Office of Chief Counsel
Internal Revenue Service

memorandum

CC:MSR:ILD:CHI:TL-N-7347-99
RAVillageliu

date: March 6, 2000

to: District Director, Illinois District

from: District Counsel, Illinois District

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subject: [redacted]
[redacted]'s Tax Basis in [redacted]
Limited Partnership at [redacted]
Individual's years at issue [redacted] through [redacted].
Individual Taxpayers' Form 1040
Statute of Limitations (IRC § 6501): Expires on [redacted]
[redacted] TEFRA Partnership proceeding statute:
TEFRA S/L for [redacted]-[redacted]: Expired.

[redacted] TEFRA Partnership proceeding statutes:
TEFRA S/L [redacted] and [redacted]: Exam reports these open.

[redacted] TEFRA partnership proceeding statute:
TEFRA Statute of Limitations [redacted]: Closed.[1]

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[1]Taxpayers, apparently, claim that [redacted], Investment partnership, filed the Forms 1065, U.S. Partnership Return for the taxable years [redacted] and [redacted], timely. Examination reports that the only Form 1065, filed for those years, verified to have been filed, is the one for the 12 month period ended [redacted]. Although the taxpayers, apparently, have produced what purports to be their retained Form 1065, for [redacted], the Service Center's records do not show a Form 1065 being filed. Examination, reports, that the partnership should also have filed a Form 1065 for the short-year ended [redacted], because a technical termination of Investment partnership occurred. Although a Form 1065 was filed for the year [redacted] (for the calendar year), Examination considers the short-year Form 1065, as an unfiled year. A TEFRA partnership Level Examination is being carried out for the year [redacted]. Examination reports that one for the short-year ended [redacted] will be carried out, based on the failure to file a [redacted] short-year return, when the partnership suffered a technical termination. In sum, the basis for both examinations is failure to file.

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[redacted]

Non-Docketed Large Case: SI (Significant Issues)[3]

On [redacted] a meeting between your office, District Counsel and representatives of the taxpayer took place. The purpose of the meeting was to afford the taxpayers representatives an opportunity to comment on why they thought that a proposed adjustment being contemplated by exam should be dropped. Due to the imminent expiration of the statute of limitations ([redacted]) the taxpayers were afraid that there would be insufficient time for anyone to review the proposed adjustment. At the conclusion of the meeting the statute was extended for 90 days specifically to allow District Counsel to

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[2]<u>See</u>, the November 23, 1999 memorandum from <u>Revenue Agent James Batory to Regional Counsel, Chicago, Attn:</u> [redacted], with regard to the [redacted]. A copy of this memorandum is enclosed as **Exhibit I**. At page 6 of said memorandum, the revenue agent argues that the Service should be consistent in the amount of outside basis recognized for [redacted] in the instant case and in the [redacted] case, and create a "whipsaw" between this case and the [redacted] case already being litigated. <u>See</u> **Exhibit I**, pg. 6. <u>See</u>, the reply memoranda dated December 6, 1999 and December 7, 1999 from [redacted] copies of which are enclosed as **Exhibits J and K**, respectively.

[3]This case requires coordination with the national office based on Litigation Guideline Memorandum TL-81 (Rev.) dated September 25, 1998. Accordingly, as we have done through this examination, we need to continue to coordinate this case with our national office. Given the imminent expiration of the statute of limitations, [redacted], and the fact that you need an analysis without further delay, we are sending this opinion to you without waiting for National Office review. But we are asking for their post-review and we will modify our advice, as necessary, to reflect the final Chief Counsel position taken in this case. Please be aware that, if a notice of deficiency is issued and litigation results, Chief Counsel may later decide to concede some or all of the issues in this case. The national office previously reviewed this case. [redacted] (b)(5)(AWP), (b)(7)c

(b)(5)(AWP), (b)(7)c

(b)(5)(AWP), (b)(7)c

review the proposed adjustment in light of the taxpayers argument.

Specifically, District Counsel was requested to review a memorandum dated [redacted] from Messieurs [redacted] to Revenue Agent James Batory re: Summary of [redacted]'s Tax Basis in [redacted] Limited Partnership (hereinafter "Investment partnership") at [redacted]. District Counsel was asked to review whether the taxpayer's [redacted] and the memoranda and exhibits cited thereto (the most important being an [redacted] letter from taxpayer's representatives) had shown that the agent's position is incorrect. Copies of the [redacted] letter and a copy of the [redacted] letter are enclosed herein as **Exhibits L and M**, respectively.

We have carried out the review that you asked us to perform. In our opinion, the facts and documents presented by [redacted] do not completely substantiate that he is entitled to take the partnership losses for the years under Examination.[4] But we believe that [redacted]'s failure of proof, in and of itself, is **insufficient** for Exam to make an adjustment disallowing the losses flowing through from [redacted].[5]

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[4]Based on our discussions with Exam we have identified the following concerns. (1) The taxpayer has not proven his outside basis in Investment partnership, to show that he is entitled to claim the losses flowing to him from Investment partnership; (2) Investment partnership has not proven its own outside basis in the intermediary partnerships, interposed between Investment partnership and the partnership which was the original debtor of each liability; Consequently, taxpayer can not show that he is entitled to a share of that liability; (3) Loans and dispositions were not adequately substantiated or accounted for in the various partnerships' books and records in that they ignore cross-collaterization and fail to account for negative capital accounts, guarantees and indemnities.

[5]Our opinion is based, in material part, on the past position of the national office, with regard to this case. As we send this case for post-review to the national office, we will ask the national office to reconsider their position once again. We are providing them with some new considerations. But, absent, a reversal of the national office's position, we can not concur with a notice of deficiency being sent out in this case, that contains the adjustment disallowing the losses flowing through from [redacted] A copy of this Request for Field Service Advice Request or Assistance is enclosed.

I. <u>DISCUSSION AND BASIC CONCLUSION</u>:

When Appeals reviewed the Revenue Agent's report dated [redacted], Appeals came to the conclusion that the adjustments as proposed were indefensible because the TEFRA statutes of the entities to which the adjustments relate have expired, and the lack of factual development of the case. A copy of the Appeals Transmittal Memorandum is enclosed as **Exhibit C.**

There is no question that the [redacted] partnerships in issue are Tax Equity and Fiscal Responsibility Act (TEFRA) partnerships subject to the unified audit procedures of I.R.C. §6221 <u>et</u> <u>seq</u>. The period of limitations for assessment under I.R.C. §6229 has passed for [redacted], the year from which the carrybacks and carryforwards, apparently, emanate. All other Investment partnership prior years, except, arguably for [redacted] and the short-year ended [redacted] are closed. <u>See</u> footnote number 1.

We have no statute information for the carryforward years, but we believe that the I.R.C. §6229 statute is also closed for said years. However, subject to the qualification discussed below in covering the statute of limitations problem, the period of limitations for assessment under I.R.C. §6501 has not passed for [redacted], and, presumably, for the carryforward/back years, for which losses are proposed to be disallowed.

The TEFRA applicability has been the subject of a number of written advisory opinions and included the participation of our National Office personnel most knowledgeable in partnership law. One theory explored was that the statute of limitations under §6229 (TEFRA) is extended by the general statute under §6501. This is an untested legal position which our National Office, as of the present time, has determined should not be argued in this case.

The general solution to the problem presented by this case was that Exam could request documents from the taxpayer and the partnerships to ascertain whether information contained in the partnership's returns, documents or books and records supported any adjustments to the taxpayers return for [redacted]. As best as we can establish, the Service has been unable to accomplish this. The voluminous documentation obtained by exam in this pursuit, while not conclusive that taxpayers have outside basis, has also, in our opinion, not shown any direct support for the proposed adjustment.[6]

Given this situation and without a fundamental change by the national office as to how it views this case, we can not support the issuance of a notice of deficiency, containing an adjustment disallowing the losses flowing through from [redacted] The rest of this opinion will provide a detailed review of the facts and the law, upon which our conclusions are based.

II. FUNDAMENTAL FACTS.

The linchpin tax year, at issue, is [redacted][7]. A disposition of assets by the [redacted]' sub-tier partnerships, resulting in carrybacks and carryforwards, occurred in [redacted]. Taxpayers (husband and wife) were investors in anywhere from [redacted] to [redacted] partnerships. One set of these partnerships was flow-through "owned" by [redacted], a limited partnership (hereinafter usually referred to as **"INVESTMENT" or "INVESTMENT PARTNERSHIP."** [redacted] had flow through "ownership" interests in a series of sub-tier partnerships, the bottom tier (most distant from Investment), owned majority interests in particular real estate ventures. As we understand it, each sub-tier partnership was engaged in one rental real estate or management venture, and there were, approximately, [redacted] ventures. Taxpayers owned [redacted]% of the Investment partnership, as limited partners. Taxpayers' wholly owned S Corporation ([redacted], [redacted]) was the general partner of [redacted] and owned [redacted]% of Investment. The balance of Investment partnership was owned by various [redacted] family trusts as limited partners.

Taxpayers, reportedly, had historically treated their interests in the rental real estate ventures as passive. It

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[6]The taxpayers failure to produce more or better proof may be due to the fact that doing so is burdensome, or the taxpayer does not have the proof due to the complexity of the case, or the taxpayer feels it has already produced plenty, or the missing proof does not help the taxpayer's case, or a combination of all of the above. No one knows.

[7]No proposed updated revenue agent report or notice of deficiency has been presented to us, but the carryback and carryforward years would also be involved. We understand that Examination proposes to disallow all partnership losses for [redacted] through [redacted] on the basis that the taxpayer has failed to substantiate his basis in the partnership. This is the only issue that Counsel has reviewed.

appears that the sub-tier partnerships, "owned" (through flow-throughs) by Investment, sustained losses that, when passed through to the taxpayers, were suspended pursuant to I.R.C. §469. During [redacted] and [redacted], some of the sub-tier partnerships disposed of all of their underlying real estate. Taxpayers' Forms K-1 from Investment property did not reflect the disposition of the underlying property. Nevertheless, the taxpayers were personally aware of the asset disposition and, accordingly, utilized their suspended losses from these partnerships on their [redacted] and [redacted] returns pursuant to I.R.C. §469(g).[8]

The utilization of the suspended losses in [redacted] and [redacted] together with other loss items springing from other partnership interests, produced large Net Operating Losses (NOLs). These losses were carried back to [redacted] and [redacted] and taxpayers filed for a tentative allowance that was paid by the Service. Subsequently, taxpayers filed a claim for refund for [redacted] and [redacted] on an unrelated matter, and that claim may still be pending. The size of the losses was sufficiently large that there are also NOL carryforwards to years after [redacted].

As mentioned above in footnote 5, the disallowance theory of the examiners, apart from the passive loss challenge which turns on whether there was a disposition of an activity, is that the taxpayers have not substantiated the bases of their interest in any of the partnerships (including substantiation of share of partnership liabilities); consequently, those bases are assumed to be zero. Hence, the taxpayers would not be entitled to deduct their share of partnership losses for [redacted] and are taxable on all distributions received in [redacted]. The agent also proposes to deny any "at-risk amount" pursuant to I.R.C. §465 on the ground that taxpayers have failed to substantiate bases.

It appears that the examining agent's adjustments require a redetermination or recomputation of such matters as: the partners' distributive shares of partnership income or loss, their shares of liabilities, their contributions, the nature of

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[8] I.R.C. §469(g) basically provides that a taxpayer's accumulated tax losses from a passive activity are allowed, without limitation in the year, when the taxpayer disposes of his entire interest in the activity in a fully taxable arm's-length transaction. The underlying rationale is that such a transaction causes the taxpayer's accumulated tax losses from the activity (taking into account any gain or loss from the disposition) to be equal to the taxpayer's overall economic loss from the activity. _See_ S. Rep. No. 313, 99th Cong., 2d Sess., at pg. 725 (May 29, 1986); 1986-3 C.B. Vol. 3, pg. 425.

partnership financing an whether the partnerships had disposed of all underlying assets. All of these are partnership items, or contain material components that are partnership items, which traditionally have required an entity level determination; and, the issuance of an FPAA.

III. FACTUALLY COMPLEX OWNERSHIP STRUCTURE MAKES THE DETERMINATION WHETHER SUBSTANTIATION OF OUTSIDE BASIS OCCURRED EXTREMELY DIFFICULT.

It is important to realize that the reason the [redacted] have been asked to provide so much information is because they ran their affairs under such a complex ownership structure. In our opinion, it is unreasonable and, probably, impossible, for the Service to establish the [redacted]' outside basis in the Investment partnership, without the [redacted] first attempting to establish their own basis. They would need to do this, by identifying each particular contributed asset, its contribution date, and its adjusted basis (with sufficient back-up documentation, for example, where FMV=AB, a trustworthy valuation report showing the particular asset value at or about the time of contribution and any debts encumbering the assets may be one way to adequately substantiate the contribution).

The [redacted]' situation regarding their outside basis in Investment partnership is extremely complicated. The diagrams in **Exhibit A** convey a flavor of this complexity. Altogether there may be anywhere between [redacted] and [redacted] entities at issue.

Prior to the creation of the partnership at issue, Investment partnership, [redacted] had an ownership interests in myriad enterprises, including [redacted] interests, [redacted], [redacted], and other businesses. Our review of the [redacted]' [redacted] and [redacted] letters, and exhibits cited therein, did not allow the Service or this office to segregate or compute what these interests were. All that we have been able to establish, to our satisfaction, is that [redacted] and his step-brother, each, roughly had a [redacted]% interest in [redacted], and that an **undetermined** portion of the liquidating distributions from [redacted] was contributed to the Investment partnership.[9]

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[9]As with everything else in this case the actual facts are more complicated than our rough approximation. Prior to liquidation, [redacted] appears to have had the following four classes of stock held, as follows: [redacted] shares of Class A nonvoting common stock held by a trust whose beneficiaries were [redacted]'s sisters; [redacted] Class B nonvoting common stock held [redacted]% by [redacted] and his [redacted] and the other [redacted]% held by

[redacted] appears to have been the top tier holding company of [redacted]'s ownership pyramid. Below [redacted], as a second corporate tier, there were, at least, three corporations (the 2nd tier corporations): [redacted], [redacted] (a/k/a "[redacted]"), [redacted], [redacted] (a/k/a "[redacted]"), and [redacted] (hereinafter "[redacted]"). There may have been other 2nd tier corporations, but we have not identified them.

[redacted], apparently, carried out the [redacted] and [redacted] business. "[redacted]" and "[redacted]", apparently, were the ones that carried out the real estate management business and held the real estate interests, an **undetermined portion** of which became [redacted]'s contribution to Investment partnership. Apparently, this 2nd corporate tier did not carry out the real estate business directly. According to our understanding, there was a 3rd tier of corporations. Examination is working on trying to determine the exact identity of these, as we speak, but to a large extent all the Service presently has, or is likely to end up with, is a rough idea of their identity.

Each of these 3rd tier corporations is believed to have been a partner, in a 4th tier ownership level. This 4th tier, apparently, is not a corporate tier, but rather mostly consisted of the partnerships actually carrying out the real estate business. From our discussion with the Examining agent, we believe that each of these partnerships, apparently, may have held a separate piece of real estate or building, or acted as a real estate management company. This review can not identify the total number of [redacted] entities involved in [redacted]'s contributions to Investment partnership. Exhibit T to [redacted]'s [redacted] letter shows a list of approximately [redacted] entities, many of them being partnerships, many of them, possibly, being intermediary corporations. The typical loan documentation file (of which there are [redacted]) involves a number of separate, intermediary entities. See **EXHIBIT G**, which represents the ownership diagram, for the [redacted] loan, one of the [redacted] loans, for which loan documentation files have been produced. It involves five separate entities, counting Investment partnership.

IV. IMPLICATIONS OF THIS COMPLEXITY.

As seen above, it is fair to infer that we are dealing with

[redacted]'s step-brother "[redacted]"; [redacted] shares of Class M voting stock held by [redacted]; and [redacted] shares of Class F voting stock held by "[redacted]", [redacted]'s step-brother.

a total of anywhere between [redacted] and [redacted] entities. The task of trying to trace real estate property (assets or partnership interests) contributions and liabilities from this bottom tier, through [redacted]'s liquidation, into the Investment Partnership is practically impossible, unless you receive total information from the taxpayers or you have unlimited resources.

What is ideal and what has not been done in this case is an actual tracing of each particular partnership asset or partnership interest that the [redacted] contributed to [redacted] together with its Adjusted Basis; **and**, a tracing of each partnership liability from the partnership that initially incurred the liability to Investment partnership, to **establish the outside basis of each intermediary partnership in the immediately preceding partnership, from which the liability allocation flows.** Neither party, the taxpayers or the Service, has been able to accomplish this. Substantial resources would be needed to review any further documents, that are produced by the taxpayers, without any degree of certainty that an adjustment would be supported. Given the previous advice we have received in this case from the national office, we can not recommend that the adjustment, at issue, be made.

V. <u>ISSUES AND SOME DISCUSSION</u>.

We now proceed to review the more salient substantive law issues present with respect to the partnership loss disallowance issue. At issue in this case is the ability of the [redacted] to deduct partnership losses passing through from [redacted] ["**INVESTMENT PARTNERSHIP**"]. The law is settled that there are, at least, three Internal Revenue Code provisions that limit the extent to which partners can deduct their shares of partnership losses: (1) I.R.C. §704(d), which limits a partner's deduction for losses to the partner's outside basis[10]; (2) I.R.C. §465,

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[10]Under I.R.C. §722, [redacted], as a contributing partner to the [redacted] partnership, takes as his basis in the partnership interest received an amount equal to the sum of the adjusted basis he had in any contributed property, plus any cash contributed. The partner's basis in his partnership interest is commonly referred to as his "outside basis." [redacted]'s outside basis is also increased by his share of the debts that the partnership incurs. This happens because the partners are deemed to contribute cash to the partnership when the partnership incurs a debt. This deemed cash contribution then increases each partner's outside basis. The converse is also true. The assumption of a partner's personal debt by the partnership is a deemed cash contribution, which reduces basis. A partner's

which limits deductions based upon nonrecourse debt; and (3) I.R.C. §469, which allows an individual taxpayer to deduct losses from "passive" activities only against income from passive activities. In addition, at issue is the effect of the closed TEFRA statutes of limitation in this case.

The taxpayers have the burden of proving that the claimed deductions are not precluded by the above limits. However, to the extent that the Service is stuck with the figures in the partnership books and records, including K-1s because of the TEFRA statute being closed, the taxpayers will be able to substantiate their case, as we understand these figures, to, generally, back their claims. The Examiners however do not believe these partnership books and records to be accurate. To prevail in this case in Court, the Service would have to test to what extent outside basis, a sum of partnership and non-partnership items, at-risk, and passive loss are subject to adjustment where the TEFRA statute of limitations is closed, but the general statute of limitations remains open.

VI. <u>ANALYSIS OF THE TAXPAYERS' [redacted] LETTER</u>.

After reviewing the taxpayers' [redacted] representations, we remain of the opinion that, **if one can go behind the partnership's books and records**, the [redacted] have not completely substantiated their outside basis.[11] Two fundamental arguments why this is true pertain to their **contributions** to [redacted] [hereinafter "INVESTMENT PARTNERSHIP"]: 1) The taxpayers have failed to show asset-by-asset the **particular** assets that were contributed to the investment partnership and what their **particular** adjusted bases were. 2) The taxpayers have failed to show whether each particular property that they contributed was encumbered by a liability, the amount of that

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outside basis is a very different thing from "inside basis." A partnership's basis in contributed, purchased, or traded property is referred to as the "inside basis."

[11] If on the other hand, the Service is stuck with the amount of contributions and allocations of liabilities, as per Investment partnership's K-1s, and other books and records, even though these figures had to originate from [redacted]'s [redacted] liquidation or from K-1s from affiliated partnerships, the [redacted] can substantiate their outside basis, by simply using the partnership's figures. A priori, the Service will have to win the right to go behind the partnership books and records to test the [redacted] outside basis, under a closed TEFRA statute. Winning this is subject to serious litigating hazards.

liability, its nature (recourse or non-recourse), any guarantees or indemnities pertaining to the particular property, and the amount of built-in gain or loss in the property, at contribution. This makes it impossible to determine the deemed cash contributions and distributions, under I.R.C. §752, that need to be computed in order to determine taxpayer's partnership interest (outside basis), at the time the partnership was formed. One fundamental argument pertains to the allocation of $[redacted] in partnership **liabilities** to the taxpayers: They have to show that each partnership in the liability chain has sufficient outside basis in the predecessor partnership to allow the liability to flow down to Investment partnership and ultimately to the [redacted].

The [redacted] have shown that there was a liquidation of Field [redacted] (hereinafter "[redacted]"). They have shown that the liquidation, occurring prior to the repeal of the General Utilities doctrine, was tax free at the corporate level, but not at the shareholder level.[12] They have pointed out that [redacted] took a fair market value basis in the assets that he received on the [redacted] liquidation, I.R.C. §334(a), but they have failed to establish what that fair market value was with respect to each or any of the particular assets contributed to the partnership.

Even if the taxpayers' conclusion (that the adjusted basis in the assets that they received from the liquidation stepped-up to fair market value) is correct, they have failed to show which **particular** assets **they received from the liquidation, which particular assets they contributed** to the partnership, and which **particular assets they retained** outside the partnership. They also have failed to show the adjusted basis (in this case fair market value at the time of [redacted]'s liquidating distribution of the asset to the [redacted]), of each **particular** asset, **[some of these assets were partnership interests]**, allegedly, contributed to the Investment Partnership.

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[12] [redacted]'s liquidation occurred prior to the repeal of the *General Utilities* doctrine. Prior to the enactment of the Tax Reform Act of 1986, former I.R.C. §336 codified the *General Utilities* doctrine, namely, that a distributing corporation was not taxable on a distribution of appreciated property. Nor could the liquidating corporation recognize a loss on the distribution of property whose basis exceeded fair market value. **Current law is different.** Under current I.R.C. §336(a) a liquidating corporation generally will be taxed on a distribution of property as if the property had been sold to the shareholders at fair market value.

Reportedly, the [redacted] received from [redacted], approximately [redacted] buildings and the land they occupied. The Service estimates that perhaps they may have received as many as 100 partnership interests from [redacted]. Examination does not have an exact count. As part of the [redacted] liquidation, the [redacted] also received a substantial amount of cash, and an installment note. Only the [redacted] have the ability to accurately demonstrate what they received from [redacted], what they contributed to the partnership (Investment), and at what adjusted basis (for their purposes, arguably, adjusted basis equals fair market value, due to the step up in basis). The Service can not be expected to do that for them. The Service can not possibly do so without sufficient facts.

Examination has engaged in substantial enforcement through IDRs and the issuance of summonses. Yet much remains undiscovered, because the taxpayers focus on broad legal theories (using aggregate figures of all assets contributed and allocations of liabilities), that fail to take into account the intermediary entities between the partnership incurring the liability and Investment. What is needed is more specifics regarding the transactions, from information other than the partnership's books and records. This detail is still missing, despite the [redacted] submissions.

As previously noted, what is needed and what the [redacted] have not provided is an actual tracing of each particular partnership asset or partnership interest that the [redacted] contributed to [redacted] together with its Adjusted Basis; **and**, a tracing of each partnership liability from the partnership that initially incurred the liability to Investment partnership. Such a showing is necessary to **establish the outside basis of each intermediary partnership in the immediately preceding partnership, from which the liability allocation flows.** To simply multiply the taxpayer's profit percentage in Investment partnership by the original amount of the liability, ignores the fact that these liabilities may not be allocable to the taxpayer because the intermediary partnerships may have already used them up, resulting in zero outside basis.

Cash contributions appear to be properly dealt with and corroborated by the taxpayer's methodology and corroborating exhibits, in the [redacted] letter. The rest of the methodology is flawed. Instead of dealing with particularity with each **specific asset contributed and its adjusted basis, and the allocation of liabilities**, the [redacted] and the [redacted] letters provide a dissertation of general legal principles of partnership and corporate law, intended to show that the taxpayers **must** have sufficient outside basis in [redacted]. The methodology used is highly abstract. It aggregates all the property contributed (except for cash) from the [redacted] liquidation into two lump sums. The sums are obtained from the net gain reported from the [redacted] liquidation in the taxpayers' Form 1040 personal returns. There is no tie-in between specific asset contributions and the net figures reported in the personal returns. The methodology uses "Total [redacted] Non-Recourse Debt" and divides it into two categories: "[redacted] Share-non-recourse debt" and "[redacted] Share Guaranteed Debt." It totals it to $[redacted]. It then multiplies this total by the taxpayers' partnership interest to arrive at an allocation to them of $[redacted]. See [redacted] letter pages 1 through 9, inclusive.

Some of the items in the computation are correct

Some of the information in the [redacted] is correct and well supported. For example, cash contributions to Investment partnership, made by the taxpayers, in each of the years [redacted] through [redacted], which are documented with references to specific checks are good substantiation.

In addition, for the years that only the general statute of limitations, I.R.C. §6501, remains open, the Service, arguably[13], **may be** bound by the distributive shares of income and losses allocated to [redacted] per the investment company schedules. To our knowledge, the Service does not possess information to question the results of the partnership's operation. This would seem to mean that, for closed TEFRA years, the Service **may have** to accept the total distributive share of income (loss) of ($[redacted]) that is being reported by Investment partnership. But this represents a reduction in [redacted]'s outside basis.

For the same statute of limitations reasons, the Service may have to accept the total amount of withdrawals and distributions from [redacted] through [redacted] of $[redacted], at page 9 of the [redacted] letter. This gives the taxpayers outside basis pro tanto. However, we note that the taxpayers' computations appear to be inconsistent. For example, at page 9, the computation treats the spin-off of Western Operations in partnership division under I.R.C. §708(b)(2)(B) as a $[redacted] distribution that **reduces**

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[13] Even if the extension theory allows the Service to adjust partnership items pertaining to items that do not reflect the actual operation of the partnership, it is an open issue whether the extension theory would extend so far as to allow the Service to adjust the results of a partnership operations gain or (loss), when the TEFRA statute is closed for that year.

the taxpayers outside basis pro tanto, but, page 4, treated the much larger $[redacted] negative tax capital account attributable to the spin-off of "[redacted]," under the same I.R.C. §708(b)(2)(B), as an **increase in the taxpayers' outside basis in the Investment partnership.** The net effect is highly beneficial to the taxpayers and detrimental to the Service, as it increases the taxpayers' ability to claim losses from Investment.

This results in a magical accounting entry, whereby the taxpayers' debt[14] to the other partners, due to the taxpayers' negative tax account, now becomes a positive adjustment increasing the taxpayers' outside basis. In other words, they increased their interest in Investment partnership by the amount of "debt" to the other partners that was never paid, and which has now been spun-off into another partnership, apparently, without recognizing debt relief income. The taxpayers appear to be mixing apples and oranges ("outside basis" and "capital accounts").

A partner can **never** have a negative basis in his interest (i.e., he can **never** have a negative **outside basis**). A negative basis is prevented by I.R.C. §704(d), which precludes a partner from claiming deductions in excess of the basis of his partnership interest and I.R.C. §731(a)(1), which provides that a partner recognizes gain on receipt of money distributions that would otherwise reduce his basis below zero. Because there are no such limitations on capital accounts, a partner may have a negative or deficit **capital** account. But this capital account is not a component of outside basis.[15]

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[14]Whether the taxpayer have a true debt, i.e., an economic risk of loss, remains undetermined. As a limited partner, [redacted] would not be liable, unless he is subject to a deficit restoration clause in the partnership agreement, for example.

[15]A partnership could, legitimately, be keeping at least three sets of accounts for one partner. Two "capital accounts" and one "outside basis" account. One **capital** account, presumably, meeting GAAP principles, would be kept for financial accounting purposes, in accordance with the financial accounting method used by the partnership. This capital account is the account that reflects the partner's equity investment in the partnership. In addition, for partnership allocations of income, gain, loss or deduction to have "substantial economic effect," a **capital account**, would need to be kept, according to the rules of Treas. Reg. §1.704-1(b)(2)(iv). Neither of these two types of **capital** accounts is an outside basis account. This is

At page 4, of the [redacted] letter, however, the taxpayers computation increases [redacted]'s outside basis computation, by his share of "negative tax capital account," as follows:

> "[redacted] Increase in basis to reflect [redacted]'s share of negative tax capital account attributable to Investment Company's interest in [redacted], which was spun-off in section 708(b)(2)(B) partnership division.* [*Footnote omitted.]. [$] [redacted]"

As taxpayers are increasing the outside basis by [redacted]'s negative or deficit account in [redacted], they, appear, to be violating a fundamental premise of the concept of outside basis, namely, that it can never be less than zero. In effect, the taxpayers are using a negative capital account figure to compute an outside basis figure. <u>See</u> footnote 14. Outside basis is a sum of many things (<u>see</u> footnote), but, we are unaware of where is the support for treating a negative or deficit **capital** account, as one of the items that increase outside basis. Perhaps, due to the operation of the I.R.C. §708 spin-off this could be the case, but we would need an explanation to accept this. If nothing else, this accounting entry, shows how far the taxpayers' theoretical treatment of outside basis wanders off from a logical, straight-forward showing of what assets they actually placed at risk in the partnership, and for what amount of liabilities they actually bore an economic risk.

Other **material** outside basis information, in the [redacted] letter, remains unsubstantiated. In our opinion, the $[redacted] contribution amount, shown at page 1 of the computation, for [redacted] and $[redacted] contribution amount, shown at page 2 of the computation for [redacted] (each allegedly representing contributions to the partnership of [redacted] liquidation assets) are not substantiated. At most, these amounts represent the amount of net gain recognized by the taxpayers in their personal returns from the [redacted] liquidation. They are not representations of adjusted basis or fair market value of any

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emphasized by Treas. Reg. §1.705-1(a)(1) which provides: "The adjusted basis of a partner's interest in a partnership is determined without regard to any amount shown in the partnership books as the partner's "capital," "equity," or similar account." The [redacted] computation appears to mix these very different types of account together.

specific assets actually shown to have been contributed. Without a further showing of which specific assets from the [redacted] liquidation were retained by the taxpayers and which were contributed to Investment partnership, it is impossible to make the logical leap from gain recognized on a personal return, to the conclusion that the gain represents an amount contributed to the partnership.

In addition, the taxpayers' methodology for computing outside basis is incorrect. It fails to inform with respect as to what specific debts encumbered the assets being contributed, and whether these debts were recourse, non-recourse, subject to guarantees or indemnities. In other words, there is no information to show what particular debts encumbered what particular assets, at the time that they were contributed.

I.R.C. §752 treats partner/partnership transactions involving increases and decreases in partner's debts as contributions and distributions of cash. If [redacted] assumed the taxpayers' debts on the contribution of assets, this is economically equivalent (and treated under I.R.C. §752) as if the partner had received cash. This would decrease the taxpayers' outside basis in the partnership, which, **at the time of the formation of a partnership before one has to take into account the results of partnership operations**, is the sum of not only the money and adjusted basis of the property a partner contributed, but also the net effect of the partnership's **constructive** "cash" distributions to that partner due to the partnership assumption of his debts, and the constructive cash contributions "made" by him, based on **his partner's** share of the debt, which the partnership has assumed.

In addition to the liability problems inherent at the time of the contribution (from failure to recognize the net constructive cash distribution effect, and from the relief of personal debt, assumed by the partnership), the methodology used by the taxpayers to allocate liabilities presents another whole set of problems. These are based on the fact that most debts were not directly incurred by Investment partnership. They were incurred by intermediary partnerships.

The [redacted] letter, at page 9, shows the taxpayers' allocable share of liabilities, as of [redacted], to be $[redacted]. This represents a huge portion of the claimed outside basis. The taxpayers' [redacted] letter included a schedule (taxpayers' Exhibit O), enclosed as **EXHIBIT H.** It purports to show the amount of Investment partnership liabilities allocable to the taxpayers, as of [redacted]. The taxpayers have also provided [redacted] loan documentation files to corroborate such liabilities. District Counsel is not in a position to examine the taxpayer, that is to read all the [redacted] "corroborating" files in the time of this review, but Examination, reportedly, has, and found them wanting. Our review of **Exhibit H**, corroborated by our review of two of the files in comparative depth, was sufficient to show us that there are material defects in the taxpayer's methodology for allocating debts.

The amount of partnership debt that would be allocated to the taxpayer can not be a simple multiplication of their interest in Investment partnership multiplied by the total amount of partnership debt incurred by an affiliated partnership remotely connected to Investment, which is what was done by the methodology of the [redacted] letter.

Determining a partner's share of debt under the Subchapter K (partnership) regulations depends on whether the debt in question is **recourse** or **nonrecourse** debt. Different rules apply to each. A partnership's nonrecourse debt is usually shared by all partners - both general and limited- according to those partners' shares of partnership profits. But there are several exceptions to the rule allocating nonrecourse debt according to profit shares [e.g., allocating nonrecourse debt equal to the "minimum gain" of particular partners; non-recourse debt secured by mortgage property is allocated to partner who would be taxed on the gain under I.R.C. §704(c) principles if property is disposed for no consideration other than relief from the nonrecourse debt; allocations are permitted according to the way deductions attributable to the liabilities will be shared in lieu of using profit shares; and special rules are made applicable or not, according to whether debt is "qualified nonrecourse financing under I.R.C. §465(b)(6)]. See Treas. Reg. §§ 1.752-3(a)(1) through (d)(1).

The only liability actually, **directly**, incurred by Investment Partnership, as per summary **Exhibit H**, is that shown as item 17, of the [redacted] letter. What it shows is that Investment partnership only directly incurred a non-recourse debt of $[redacted] and a guaranteed debt of $[redacted]. Immediately, we note a problem, [redacted] is only a limited partner in Investment partnership. Limited partners are not liable for partnership debts, so [redacted], as a limited partner, would not be obliged to pay any of the debt in question. Even, if [redacted], himself, guaranteed the payment of the debt, the debt would normally be allocated to the only general partner. This is because if there is a financial collapse of the partnership and [redacted] actually has to pay the debt, he will have a right of repayment from the general partner. See Treas. Reg. §1.752-2(f)(Example 4).

As to this directly incurred nonrecourse debt, the taxpayer's treatment of simply multiplying the taxpayer's interest (presumably profit interest) by the amount of the debt would, generally, be correct. Recall that a partnership's nonrecourse debt is usually shared by all partners - both general and limited - according to those partners' shares of partnership profits. However, without knowing the fair market value of the particular property contributed in comparison to the specific liability that encumbered the property one can not conclude that the exception under principles of I.R.C. §704(c) to the rule allocating nonrecourse debt according to profit shares is inapplicable.[16]

Therefore, it can not simply be concluded that [redacted] is entitled to an allocation of liabilities simply based on his percentage of ownership in the partnership. Each particular liability must be considered separately for allocation purposes.

The problem with the taxpayer's methodology is compounded when we begin to consider liabilities that were not directly incurred by Investment partnership. This is the case for all the other 39 liabilities, for which the taxpayers have provided loan folders. A review of these liabilities shows that they have been pooled by the different intermediary partnerships, in mutual pools, for security purposes. Therefore, it is impossible to tell which particular liability is recourse or non-recourse, as to any one of the intermediary partnerships.

In addition, the fact that the taxpayers have not shown their outside basis or Investment partnership's outside basis, in each of the intermediary partnerships, means that they have not substantiated that they are entitled to an allocation of liabilities from any of those partnerships. Even if a partnership owes $[redacted] to a bona fide third party, Investment partnership, and, by flow through, the taxpayers, would not be entitled to an allocation of that liability, unless they could first show that they had sufficient outside basis in the debtor partnership. Any number, no matter how great, multiplied by zero is still zero. If this were not the case, each intermediary partnership would be able to fully utilize the liability in

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[16]Sometimes gain on the disposition of mortgaged property must be allocated to particular partners under principles set forth in I.R.C. §704(c). When this is the case, nonrecourse debt secured by the mortgaged property is allocated to the partners who would be taxed on the gain if the partnership disposed of the property for no consideration other than relief from the nonrecourse mortgage. See Treas. Reg. §1.752-3(a)(2).

claimed deductions, and allow the next partnership down the line to do the same. This would be a multiplication of the same deduction.

Therefore, we conclude that the taxpayers' methodology, as set forth in page 9 of the [redacted] letter, is wrong. It is incorrect to allocate $[redacted] of liabilities to the taxpayers, as of [redacted], by simply basing this allocation on the taxpayers' profit share in [redacted] multiplied by Investment's profit share in each loan intermediary, until the original loan debtor partnership is reached.

However, even though the taxpayers' calculation, as per the [redacted] letter leaves much to be desired, this is insufficient for an adjustment. The taxpayers can simply substantiate their case, as per the figures in Investment Partnership's books and records. These can not be adjusted, given closed TEFRA statutes for [redacted] through [redacted]. They must be accepted as true[17] because, for the most part, the Service, traditionally, treats them, as partnership level determinations.

VII. <u>THE SERVICE'S THEORY, TO DISALLOW THE LOSSES, HINGES ON A REDETERMINATION OR RECOMPUTATION OF WHAT THE TEFRA PROVISIONS INDICATE TO BE PARTNERSHIP ITEMS, OR AFFECTED ITEMS THAT MOSTLY CONSIST OF COMPONENTS REPORTED ON THE PARTNERSHIP RETURNS</u>.

I.R.C. §§ 6221-6233 (the TEFRA provisions) provide a comprehensive scheme for the examination, adjustment and adjudication of items at the partnership level, as opposed to the partner level.

I.R.C. §6231(a)(1)(A) defines a partnership as any partnership required to file a return under I.R.C. §6031(a). Section 6331(a)(1)(B) exempts from the TEFRA procedures partnerships of ten or fewer partners each of whom is a natural person whose share of each partnership item is the same as his share of every other partnership item. Therefore, Investment partnership is not exempt from the TEFRA procedures. Investment partnership is a TEFRA partnership.

I.R.C. §6231(a)(3) defines a partnership item as any item required to be taken into account for the partnership's taxable year under any provision of subtitle A of the Code, to the extent that regulations prescribed by the Secretary provide that such

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[17] This is true, absent a change of position by the national office regarding litigating the statute extension theory in this case.

item is more appropriately determined at the partnership level than at the partner level.

Treas. Reg. §301.6231(a)(5)-1T(b) provides that a partner's basis in his partnership interest ["outside basis"] is an affected item to the extent it is not a partnership item.

Treas. Reg. §301.6231(a)(5)-1T(c) provides that the application of the at-risk limitations under I.R.C. §465 with respect to a loss flowing from a partnership is an affected item to the extent it is not a partnership item.

Treas. Reg. §301.6231(a)(3)-1(a)(1)(i)-(v) provide that the partnership aggregate and each partner's share of all items of income and loss of the partnership are partnership items. Moreover, the partnership aggregate and each partner's share of partnership liabilities (including determinations with respect to the amount of the liabilities, whether the liabilities are nonrecourse, and changes from the preceding taxable year) are partnership items.

Treas. Reg. §301.6231(a)(3)-1(a)(4) provides that items relating to contributions to and distributions from a partnership are partnership items to the extent that a determination of such items can be made from determinations that the partnership is required to make with respect to an amount, the character of any amount, or the percentage interest of a partner in the partnership for purposes of the partnership books and records or for purposes of furnishing information to a partner.

The foregoing statutes and regulations indicate that the determination of a taxpayer's share of partnership liabilities which is includable in basis is a partnership item. Similarly, contributions and distributions from a partnership, as well as disposition of the underlying assets of the entity are partnership items. It follows that the examiners' theory of disallowance hinges on a redetermination or recomputation of partnership items reported on the partnership returns, and affected items.

VIII. <u>AN INDIVIDUALIZED REVIEW OF OUTSIDE BASIS, AT-RISK, AND PASSIVE LOSSES SHOW THAT THE SERVICE HAS, TRADITIONALLY, ADJUSTED THESE COMPONENTS BY THE ISSUANCE OF AN FPAA, NOT A SND</u>.

In the past, the Service has treated most components of outside basis, and many of the components of at-risk, and passive loss as partnership items, for which an FPAA must be issued, under an open TEFRA statute.

This is shown by a February 4, 1992 memorandum from the Chief, Passthroughs and Special Industries Branch CC:P&SI to the Tax Shelter/TEFRA Coordinator EX:E:S, National Office Examination. A copy is enclosed as **Exhibit B.**[18] The memorandum outlines the Service's position for the following partnership affected items: Basis, At-Risk, and Passive Activity Losses. These are the same items, at issue in the instant [redacted] case.

The February 4, 1992 memorandum begins by recognizing that these affected items have partnership item components, yet require factual determinations at the partner level. This, of course, is at the core of the [redacted]' case where adjustments to the [redacted]' outside basis may be predetermined, by the fact that the TEFRA statute is closed for making partnership adjustments. At page 5 of said memorandum (**Exhibit B**) it is concluded that the partnership level components of **outside basis** that **should be set forth in a FPAA notice** are, as follows:

<u>Basis</u>:

1. amount of the initial contribution to the partnership[19];

2. amounts of all subsequent contribution to the partnership;

3. amounts of distributions from the partnership; and

4. amounts of partner's share of non-taxable income, taxable income, losses and deductions.

The only partner level determination of [outside] basis which is identified occurs when a partner buys his partnership interest from another partner (and this is not subject to a I.R.C. §754 election). In that case, the purchase price of the partnership interest is the partner's basis, but there is no requirement that the purchase price of the partnership interest be taken into account for the partnership taxable year.

From the above, it should be obvious that the Service has a problem due to the closed I.R.C. § 6229 statutes of limitation. The Service can not issue an FPAA for the taxable years [redacted] through [redacted], at issue, since the TEFRA statute is closed. For example, one of the fundamental flaws in the [redacted]'

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[18]**Exhibit B** is incomplete. It is a seven page memorandum that is missing one page, page number 7. The information we are relying upon is found in pages 4 and 6, which we do have.

computation is that they have not proven their **initial contributions** to the partnership, by going behind the partnership records. But the Service has not shown that the partnership books and records are incorrect either, and with TEFRA closed they remain unadjusted at the partnership level.

If the amount of the taxpayers' **contribution** is truly a partnership level component, and if it can only be adjusted by an FPAA, the Service may be forced to accept the unadjusted partnership's books and records, as conclusive irrebuttable proof of the [redacted]' initial contribution. In issuing a 90-day letter to the [redacted] disallowing their losses based on failure to substantiate outside basis, based in part on their failure to prove initial contributions, the Service will be inconsistent with its usual practice that determines this item by the issuance of an FPAA, not a personal notice of deficiency.

At page 5 of said February 4, 1992 memorandum (**Exhibit B**) it is also concluded that the partnership level components for **at-risk** that **should be set forth in a FPAA notice** are, as follows:

<u>At risk</u>:

1. Was a particular loan recourse or nonrecourse;

2. Did the partner bear the ultimate economic risk of loss with respect to a particular partnership liability;

3. The amount of the note:

4. Whether a partner is a limited or general partner;

5. Whether the lender has an interest other than as a creditor.

Some of the partner level determinations for at-risk are whether there are third party side agreements (stop loss agreements) or whether the partner borrowed money contributed to the partnership from another partner. Once again from the above, it should be obvious that the Service has a problem in disallowing the [redacted]' losses, as the Service can not issue an FPAA for their taxable years [redacted] through [redacted], at issue.

One of the fundamental flaws in the [redacted]' computation is that they have not proven their allocation of partnership liabilities for outside basis purposes and for at risk purposes, by going behind the partnership records, to show that they had the risk of loss with respect to the liability. But the Service has not shown that the partnership books and records are incorrect either.

If the amount of the **partnership allocations** are truly partnership level components, and if they can only be adjusted by an FPAA, the Service would be forced to accept the unadjusted partnership's books and records, as conclusive irrefutable proof of the [redacted]'s **share of partnership liabilities and amount at risk.** Again, were the Service to issue a 90-day letter to the [redacted], disallowing their losses based on lack of substantiation of outside basis and amount at-risk, based in part on their failure to prove their partnership liability allocations, the Service may be viewed as being inconsistent with its own position, as set forth in the [redacted] memorandum, that determines, most of the components of these items to be FPAA determinations.

Finally, missing page 7 of the February 4, 1992 memorandum (**Exhibit B**) does not allow us to state categorically what partnership level components for **passive loss should be set forth in a FPAA notice.** Page 4 of **Exhibit B** only implies that an FPAA notice would include issues such as the following.

Passive Loss:

1. A determination that a partnership is engaged in rental activity, which is generally a passive activity regardless of the degree of material participation by the partner; and,

2. A determination that a partnership is engaged in a trade or business.

At page 4, of the February 4, 1992 memorandum, **Exhibit B**, it is pointed out that the characterization of a credit or loss, as attributable to a passive activity for purposes of I.R.C. §469, potentially requires at least three basic determinations: (1) whether the activity involves the conduct of a trade or business; (2) whether the partnership interest is a limited or general interest; and(3) if it is a general partnership interest, whether the taxpayer materially participates in the activity.

IX GIVEN CLOSED TEFRA STATUTES, THE NATIONAL OFFICE PREVIOUSLY CONCLUDED THAT INVESTMENT'S PARTNERSHIP'S BOOKS AND RECORDS FOR THE CLOSED [redacted] YEAR, ARE CONCLUSIVE EVIDENCE OF THE MATTERS WHICH THEY CONTAIN. IN A MORE APPROPRIATE CASE, NOT THIS CASE, THE SERVICE IS WILLING TO ARGUE OTHERWISE.

On, at least, two different occasions, our national office has provided advice that, the instant case is not a good litigation vehicle for testing the Service's statute of limitations "extension" theory, present in the case. See enclosed **Exhibits D and E, and N** memoranda from CC:DOM:FS dated March 25, 1996 and November 13, 1997, and February 20, 1998, respectively.

Previous national office review
of this case militates against issuing
a SND disallowing the partnership losses

At various times, our office and the national office reviewed various aspects of this case, formally and informally. Examination has been provided with copies of these. As early as March 25, 1996, the national office, **essentially,** agreed with the district counsel attorney working the case at the time, with respect to the following:

At pg. 3, of **Exhibit D** (3/25/96 memorandum), the district Counsel attorney's **first** legal conclusion was, as follows:

1. That no adjustment for [redacted] is realistically possible because the TEFRA statute of limitations has passed for [redacted]. A challenge to basis of the partnership in partnership property, capital account, and partnership liabilities, where not partnership items in total, have component aspects that are partnership items and these may not be challenged given a barred TEFRA statute for [redacted].

The national office agreed that, to the extent an adjustment to taxpayer's [redacted] taxable year losses turns on a partnership item component of the passive loss limitation, the adjustment **should not be pursued** [**Emphasis added**]. After noting that the extension theory could be a possible solution. The national office **hastened to add** that "**because there is no clear judicial approbation of the statute extension theory, we** ... [national office]... **really doubt that this highly complex case** ... [the [redacted] case]... **is the appropriate vehicle for advancing that theory.**" See **Exhibit C,** at pgs. 3-4.

As shown at page 3 of **Exhibit D,** the district Counsel attorney's **second** legal conclusion was, as follows:

2. That the taxpayers have filed consistently with the source sub-tier partnerships and satisfied the consistency requirement of I.R.C. §6222(a). See Temp. Treas. Reg. §301.6222(a)-

> 2T(b). Further, no computational adjustment under I.R.C. §6222(c) is possible even if the taxpayers did not file consistently because the TEFRA period of limitations has expired;

The national office also agreed with this district counsel finding concerning the consistency adjustment under I.R.C. §6222. <u>See</u> **Exhibit D**, at page 4.

As shown at page 3 of **Exhibit D**, the district Counsel attorney's **third** legal conclusion was, as follows:

3. That the carryforwards for future years can be disallowed because the merits of a carryback or carryforward to an open year is fully determinable notwithstanding that the source year of the carryover is barred by the TEFRA period of limitations. The corollary of this conclusion is that taxpayers' claims for [redacted] and [redacted] could be offset by the recalculated carryback.

The national office also agreed with the district counsel's analysis that the Tax Court was "free to determine entitlement to a carryforward and the amount of the carryforward to a deficiency year notwithstanding that the carryforward is sourced in a partnership item in a year barred by the passage of the [**TEFRA**] period of limitations." <u>See</u> **Exhibit D**, at pg. 4.

In a Field Service Advice Memorandum dated November 13 1997, enclosed **Exhibit E**, our national office, reviewed their prior March 26, 1996 memorandum. The national office made it clear that it did not view the [redacted] case as the proper litigation vehicle, to challenge the view that a closed TEFRA statute forecloses partnership item adjustments, when the general statute of limitations remains open. The national office summarized its prior opinion, as follows:

> "On March 25, 1996, we advised that, although the Service now believes that I.R.C. §6229 extends the limitation period described in I.R.C. §6501, the extension theory has inherent risks which are amplified in the context of the instant case. [**The** [redacted] **case**]. We explained that risk amplification stemmed from the weakness of one of the substantive positions taken by the Service, that position being the sale of the assets of a partnership was not a disposition for purposes of I.R.C. §469(g). [**Footnote**

> **omitted**]. We also indicated that taxpayers' consistent filing for purposes of I.R.C. §6222(a) was problematic because consistent filing with the returns of the underlying partnerships arguably demonstrates taxpayers' compliance with the unified partnership procedures; accordingly we would be hard-pressed to urge a departure from the procedure. Moreover, we expressed agreement with your view [**district counsel's view**] that no adjustment for [redacted] was realistically possible because the TEFRA period of limitations had passed for that year and a challenge to the partners' bases in the partnership depended on a redetermination of such matters as, the partners' distributive shares of partnership income or loss, their shares of liabilities, and their contributions, all of which require an entity level determination. We expressed optimism about the prospect of challenging the NOL carrybacks and carryforwards on the strength of Durrett v. Commissioner, T.C. Memo. 1994-179 (1994) and Harris v. Commissioner, 99 T.C. 121 (1992) which indicate that the Service has more latitude to determine entitlement to a carryforward/carryback to a deficiency year notwithstanding that the carryforward/back is sourced in year that is not before the court, the item is a partnership item subject to the unified audit provisions, and adjustment to the item would otherwise be barred by settlement or the passage of the period of limitations." See **Exhibit E**, at pg. 4.

The national office, then, went on to review the whole case, de novo, taking into account the statute extension theory. **Even after considering this theory**, the national office once again concluded that this was not the litigating vehicle to assert the statute. More, specifically, the national office concluded that there were "**serious litigating hazards**" in pursuing the statute of limitations theory(the extension theory) and in challenging the NOL carrybacks or carryforwards present in this case. In finding serious litigation hazards, with respect to the NOL carryforwards/backs, the second opinion was even more discouraging with respect to the partnership loss disallowance issue than the first opinion. The first opinion was more positive with respect to the NOLs disallowances.

Although the national office did not completely slam the door on adjustments being made in this case, it only left open a narrow window of opportunity. In the words of the national office:

> "...The Service ...[can]...determine whether the information sufficient to substantiate any adjustments is found in partnership documents previously filed with the Service or appeared in the partnership books and records. If such information is present in this case,...[[redacted]'s case]...the adjustments at the partner level may be supported." See page 11 of enclosed **Exhibit E**, at pg. 11.

Since that second review, the national office has issued TL-81 (Rev), September 25, 1998, CC:DOM:FS:P&SI, enclosed as **Exhibit F.** It made clear that the position of the Service is, in pertinent part, as follows:

> "It is our position that section 6501 is the controlling limitation on assessment, and that to the extent applicable, section 6229 merely serves to extend the section 6501 general limitation on assessment. In effect, the limitation on assessment of tax attributable to partnership items is the longer of section 6501 or 6229 [citation omitted]. Accordingly, to the extent an assessment is timely under either provision, the statute of limitations should not serve as a bar against assessment." See, TL-81, **Exhibit F**, at pg. 16.

However, TL-81, **Exhibit F**, makes it clear that **not every case presenting the statute extension theory is to be defended.** This is set forth in TL-81, in pertinent part, as follows:

> "Although it is the view of our office that section 6229 only sets forth a minimum assessment period which serves to extend the section 6229 statute of limitations on assessment, there are situations in which a notice of deficiency that is issued in a timely manner under this analysis but after expiration of the section 6229 minimum assessment period will not be defended. ... **Any case which advances the argument that a notice was timely under section 6501, despite the fact that the notice was not issued within the 6229 minimum assessment period, must be coordinated with the National Office.**" [Emphasis in the original.]. See, TL-81, **Exhibit F**, at pg. 14.

Examination's adjustments against the [redacted] will, necessarily, disregard many of the partnership item figures on e Investment partnership's own books and records. Although their review of the instant opinion, will show us whether the national office continues to believe that the instant case is not the type of case to test the statute extension theory, we do not want to give you any false hope.

X. <u>FACTUAL DEVELOPMENTS SINCE THE CASE WAS REVIEWED BY APPEALS AND THE NATIONAL OFFICE</u>.

The factual development of this case, since those evaluations, is limited. Examination continues to obtain sufficient documentation from the taxpayers to determine <u>the correct</u> outside basis, etc. Taxpayers have produced the [redacted] letter. But noting has fundamentally changed, In our opinion, the taxpayers still can not prove that they are entitled to the losses, **if we disregard the partnership's books and records**. But the Service also still can not prove the wrongdoing by affirmative evidence.

As previously noted, what we really have is a case where the taxpayers can not, or will not substantiate their basis, by providing a complete accounting (backed by sufficient primary documentation) of their partnership interest and their partnership liability allocation, **with proof in addition to that which their partnership's books and records show.**

But the taxpayers claim that they have already substantiated their losses, and that this would be clear, if the Service could only follow the taxpayer's sophisticated legal explanations. Therefore, taxpayers claim that they have already provided ample documentation to substantiate the claimed losses, and that the Service is just not grasping that, the weight of the evidence produced could persuade a Court.

<u>Other Changes since the national reviewed the case</u>

One change that has occurred since the national office reviewed this case, of potential significance, is the litigation between the taxpayers and the Service in the [redacted] case. As a reading of the memoranda discussed in footnote 2 shows, the examiner believes that taxpayers are taking inconsistent positions between the instant case, that the Investment partnership books and records are conclusive proof, and their litigation, where, the Examiner believes that taxpayers are going behind those books, in the different year [redacted] (also closed by TEFRA), to establish additional basis. From the disagreements shown in the memoranda going back and forth between the Examiner and the Special Trial Attorney, we can not conclude the extent to which the examiners concerns are born out by the facts of the case. The possibility that this inconsistency exists, however, is one reason the national office may choose to revisit its decision not to assert the statute extension theory in this case.

XI. CONCLUSION.

To summarize, after years of examination, a great many of the **material facts** necessary to correctly determine whether or not the [redacted] erred in claiming these losses remain buried, in the complexities of this case. Examination has not been able to pinpoint any particular acts or omissions by the [redacted] that, conclusively, show that the losses claimed were incorrectly claimed. What we have is a situation where taxpayers can not show that the losses claimed were correctly claimed, in that they have not shown **material** facts normally needed to compute **contributions and a partner's allocation of partnership liabilities. BUT THIS IS TRUE ONLY IF THE SERVICE IS FREE TO IGNORE INVESTMENT PARTNERSHIP'S BOOKS AND RECORDS, AND GO BEHIND THESE BOOKS. As we understand the case, the Service is not free to do this.** If there is a modification of national office position, we will inform you.

This concludes our analysis of the [redacted] letter and exhibits. We understand that Examination will be proposing many other adjustments against the taxpayers, in addition to the one we have been asked to review. We also understand that, these may merit the issuance of a notice of deficiency, for any of the open years. These other adjustments have not presented to us for our review. We express no opinion on them, in this opinion. If a notice of deficiency is sent for review, with sufficient time to review it, we will examine any proposed adjustments set forth therein, to the extent time permits us.

If you have any questions, please contact the undersigned at (312) 886-9225, extension 308.

RICHARD A. WITKOWSKI
District Counsel

By: Rogelio A. Villageliu
ROGELIO A. VILLAGELIU
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Enclosures: **Exhibits A through O**, as stated.Full set of Exhibits to all.

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